

Proposed Rules May Lead to Increased Short Selling of Canadian Securities

On September 7, 2007, Market Regulation Services Inc. (RS), which administers and enforces trading rules for Canadian marketplaces, including the TSX, TSX Venture Exchange, CNQ and ATS systems, published for comment a series of proposed changes to the existing rules governing short selling. The proposals are subject to a one-month comment period that will expire on October 9, 2007.

Most significantly, these proposed rules would repeal the existing “tick test” – in other words, remove the restrictions on the price at which a short sale may be made. Under the current rules, market participants may not generally make a short sale of a security unless the price is at or above the last sale price for that security (normally determined by reference to trading information from the principal market for that security). The proposed rule, however, would provide a new discretion to RS to designate a security as ineligible to be sold short. RS has indicated that it would expect to exercise that discretion if, in its view, there is evidence of excessive “failed trade” rates in a security, and that the discretion would be exercised only with the agreement of the applicable Canadian securities regulators.

Another important proposed change, from the perspective of market participants, is to remove the requirement on market participants to file twice-monthly short-position reports, subject to the future general availability of information on short sales. RS has indicated that, in its view, the availability criteria will be met if third parties regularly (no less frequently than semi-monthly) disseminate periodic summary reports of short sales effected on marketplaces in particular securities.

The proposed rule changes would also require market participants to get RS approval before varying or cancelling a trade, and to report to RS if a trade that has failed to settle on the settlement date remains unresolved for 10 trading days following the settlement date, with a second report to be filed once the default has been cured. RS would have the discretion, in certain circumstances, to cancel failed trades.

These proposed rule changes follow a study of short selling rules begun by RS in October 2004, which encompassed, among other things, a close review of evolving short selling rules and market impact studies in the U.S., the U.K. and elsewhere. The proposed changes would move Canadian marketplace practices closer to those of U.S. marketplaces, which saw in July 2007 a similar repeal of tick tests. The proposed RS rules, however, do not import certain burdensome U.S. requirements, including the “locate requirement,” which requires a broker, before effecting a short sale, to either borrow or enter into an agreement to borrow, or have reasonable grounds to believe that the security sold short can be borrowed so that it can be delivered in normal course settlement. As well, the proposed rules do not conform to certain other recently adopted or proposed U.S. rules, including those that require marketplaces to maintain “fails lists” of securities, for brokers to comply with special “close-out requirements” and further limitations on short selling in respect of those securities, and documentation requirements for sales indicated as from a “long” position.

The adoption of the proposed new rules can be expected to make short selling easier and less costly for market participants trading Canadian securities in Canadian marketplaces. (Canadian dealers who sell short Canadian securities in U.S. marketplaces must, of course, comply with the applicable U.S. rules.) RS has indicated that if the proposed rules are implemented, it will be important to assess their effect on Canadian marketplaces and that it will conduct a study to examine, among other things, the impact of the new rules on volatility, liquidity and fail rates.

For the text of the proposed rules, please see “RS Market Integrity Notice – Request for Comments – Provisions Respecting Short Sales and Failed Trades” in the OSC Bulletin, Issue 30/36, September 7, 2007.

* * * * *

To contact us, to change your mailing options or to unsubscribe, please email us at info@torys.com or call us at 416.865.7500, extension 8500. If you are calling long distance from anywhere in the continental United States and Canada, you may use the toll-free number 1.800.505.TORY (8679), extension 8500. Torys’ client memos and bulletins are available on our website at www.torys.com, under Publications. Our privacy policy is also available on our website.

This client memo is a general discussion of certain legal and related developments and should not be relied upon as legal advice. If you require legal advice, we would be pleased to discuss with you the issues raised by this client memo in the context of your particular circumstances.